



2005 ANNUAL REPORT

# Corporate Information

## **Directors**

R.W. Shepherd  
Calgary, Alberta

Gordon F. Dixon  
Calgary, Alberta

Garry Tether  
Cochrane, Alberta

Bruce Francis  
Calgary, Alberta

## **Officers**

R.W. Shepherd  
President

Gordon F. Dixon  
Corporate Secretary

## **Head Office**

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## **Web Site**

[www.blackpoolexploration.com](http://www.blackpoolexploration.com)

## **Corporate Counsel**

Beaumont Church LLP  
Calgary, Alberta

## **Auditors**

BDO Dunwoody LLP  
Chartered Accountants  
Calgary, Alberta

## **Banker**

Alberta Treasury Branches  
Calgary, Alberta

## **Registrar & Transfer Agent**

Computershare Inc.  
Calgary, Alberta

## **Engineering Consultant**

Fekete Associates Inc.  
Calgary, Alberta

## **Stock Exchange Listing**

TSX Venture Exchange  
Trading Symbol: BPX.A

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## **Annual Meeting of Shareholders**

The Annual Meeting of Shareholders of Blackpool Exploration Ltd. will be held in the Marie Wright #2 Room of the Delta Calgary Airport Hotel, Calgary, Alberta at 10:00 am, Thursday, July 6, 2006.



## **BLACKPOOL** Exploration Ltd.

# Message to our Shareholders

During the second quarter of 2005, Blackpool closed a deal to acquire all of the issued and outstanding shares of a private company, C2 Energy Inc. The purchase price of this transaction included a cash component of \$12.5 million. Those parties engaged to raise this amount on behalf of the Company delivered only \$8.5 million. This shortfall was financed with part of a \$4.5 million bridge financing and also resulted in a deficiency in funding of qualifying flow through share expenditures in the amount of approximately \$4.5 million. Two and a half million dollars of this bridge financing was repaid by late December 2005 and the remaining two million dollars was refinanced with a merchant banking concern in eastern Canada. The Company has funded approximately \$1.6 million of flow through activity to date with \$2.9 million to spend by year end 2006. In spite of the foregoing difficulties, the Company participated in the drilling of 9 wells in the period from closing of the C2 deal to present with all wells cased and only one subsequent abandonment. As none of these properties are operated, Blackpool has been subjected to the agenda of another party with respect to the timing of field activity to prepare these wells for the taking of production and so only one well is currently on production.

Based on the foregoing, the market has responded unfavourably to the Company's ongoing bridge financing indebtedness and the unfinanced flow through share expenditure requirement. As a result, management is taking steps to increase the Company's credit facility based on expanded asset value in our December 31, 2005 third party engineering report to pay out a major portion of the existing bridge financing. Also, the Company will dispose of certain non-producing assets to provide an influx of cash which will fund up to \$2 million of drilling activity in addressing the Company's flow through share obligations. The balance of flow through expenditures will be financed out of cash flow as new production comes on stream and/or with proceeds of a financing in the third quarter of this year.

We wish to emphasize that after taking the foregoing action, Blackpool will have an expanded production base from the C2 acquisition, a land resource of more than 65,000 gross acres and 27,500 net acres, supporting seismic of more than 350 miles of 2 dimensional data and more than 80 square miles of 3 dimensional data, production from drilled wells to be tied in, and the potential upside associated with an internally generated and continually growing prospect inventory.

Management thanks those shareholders who have shown great patience over the last year as the Company has dealt with a number of challenges. We look forward to a prosperous year ahead in an ongoing environment of strong commodity prices.

Submitted on behalf of the Board of Directors

*Signed*

**Ronald W. Shepherd**  
President

June 2, 2006

*Signed*

**Garry Tether**  
Director

# Auditors' Report

**To the Shareholders of  
Blackpool Exploration Ltd.**

We have audited the consolidated balance sheets of Blackpool Exploration Ltd. as at December 31, 2005 and 2004 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*S i g n e d*

**BDO Dunwoody LLP**

Chartered Accountants

Calgary, Alberta

April 7, 2006

# Consolidated Balance Sheets

	(in Canadian dollars)	
December 31,	2005	2004
<b>Assets</b>		
Current		
Cash and cash equivalents	\$ 290,178	\$ –
Accounts receivable	978,063	304,913
Prepaid expenses and deposits	87,516	54,879
Deferred financing fees (note 6)	95,240	–
	1,450,997	359,792
Goodwill (note 3)	797,900	–
Property and equipment (notes 3 and 4)	18,980,150	2,067,172
	<b>\$ 21,229,047</b>	<b>\$ 2,426,964</b>
<b>Liabilities</b>		
Current		
Accounts payable and accrued liabilities	\$ 1,198,530	\$ 147,542
Operating loan (note 5)	2,175,000	974,674
Credit facility (note 6)	1,512,147	–
Shareholders' loans (note 7)	300,000	–
	5,185,677	1,122,216
Asset retirement obligations (note 8)	467,270	277,340
Future income taxes (note 12)	3,327,619	150,977
	8,980,566	1,550,533
<b>Shareholders' Equity</b>		
Share capital (note 9)	8,921,254	888,940
Warrants (note 10)	3,460,132	9,383
Contributed surplus (note 11)	773,660	85,164
Deficit	(906,565)	(107,056)
	12,248,481	876,431
Nature of operations and going concern (note 1)		
Commitment (note 9(c))		
Subsequent event (note 17)	<b>\$ 21,229,047</b>	<b>\$ 2,426,964</b>

On behalf of the Board

Signed

**R. W. Shepherd**  
Director

Signed

**Gordon F. Dixon, QC**  
Director

See accompanying notes

# Consolidated Statements of Operations and Deficit

		( i n C a n a d i a n d o l l a r s )
Years Ended December 31,	2005	2004
<b>Revenue</b>		
Petroleum and natural gas sales	\$ 3,278,030	\$ 1,377,522
Royalties, net of Alberta Royalty Tax Credit	(529,893)	(219,656)
	<b>2,748,137</b>	<b>1,157,866</b>
<b>Expenses</b>		
Production	686,575	399,617
Transportation	16,415	8,460
General and administrative	643,777	339,784
Stock based compensation	—	85,164
Interest	313,256	67,349
Financing fees	144,230	—
Accretion	26,503	22,264
Depletion and depreciation	2,171,076	270,970
	<b>4,001,832</b>	<b>1,193,608</b>
Loss for the year before taxes	(1,253,695)	(35,742)
<b>Income taxes</b> (note 12)		
Future tax (recovery) provision	(454,186)	38,725
<b>Net loss for the year</b>	<b>(799,509)</b>	<b>(74,467)</b>
Deficit, beginning of year	(107,056)	(32,589)
<b>Deficit, end of year</b>	<b>\$ (906,565)</b>	<b>\$ (107,056)</b>
<b>Net loss per share – basic and diluted</b> (note 9)	<b>\$ (0.04)</b>	<b>\$ (0.01)</b>

See accompanying notes

# Consolidated Statements of Cash Flows

		(in Canadian dollars)	
Years Ended December 31,	2005	2004	
<b>Operating</b>			
Net loss for the year	\$ (799,509)	\$ (74,467)	
Add back (deduct) non-cash items			
Depletion and depreciation	2,171,076	270,970	
Stock based compensation	—	85,164	
Accretion	26,503	22,264	
Financing fees (note 6(b))	19,930	—	
Future income tax (recovery) provision	(454,186)	38,725	
	963,814	342,656	
Changes in non-cash working capital (note 15)	1,395,859	(45,350)	
	2,359,673	297,306	
<b>Financing</b>			
Proceeds on share issues, net of costs (note 9)	10,221,323	87,669	
Net operating loan advances	347,377	(375,326)	
Proceeds from promissory note	4,500,000	—	
Repayments of promissory note	(4,500,000)	—	
Proceeds from credit facility (note 6(b))	1,800,000	—	
Financing fees (note 6)	(100,195)	—	
Proceeds from shareholder loans (note 7)	300,000	—	
	12,568,505	(287,657)	
<b>Investing</b>			
Expenditures on property and equipment	(2,121,299)	(218,687)	
Proceeds on disposal of property and equipment	519,348	175,869	
Acquisition of C2 Energy Inc. (note 3)	(11,940,565)	—	
Cash acquired from C2 Energy Inc. (note 3)	23,457	—	
Changes in non-cash working capital (note 15)	(1,118,941)	16,250	
	(14,638,000)	(26,568)	
Increase (decrease) in cash	290,178	(16,919)	
<b>Cash and cash equivalents, beginning of year</b>	—	16,919	
<b>Cash and cash equivalents, end of year</b>	<b>\$ 290,178</b>	<b>\$ —</b>	
<b>Supplemental cash flow information</b>			
Interest paid	\$ 307,209	\$ 67,349	

See accompanying notes

# Notes to the Consolidated Financial Statements

December 31, 2005 and 2004

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## **Note 1: Nature of operations**

Blackpool Exploration Ltd. (the "Company") is engaged in the exploration for and production of petroleum and natural gas predominantly in Western Canada. The Company was incorporated under the laws of the Province of Alberta on December 3, 1992 and is listed on the TSX Venture Exchange.

These consolidated financial statements have been prepared on a going concern basis which contemplates the realization of assets and the payment of liabilities in the ordinary course of business. As at December 31, 2005, the Company had a working capital deficit of \$3,734,680 (2004 – \$762,424) and a commitment to incur approximately \$3,336,000 of qualifying flow through expenditures by December 31, 2006 (note 9). Should the Company be unable to continue as a going concern, it may be unable to realize the carrying value of its assets and to meet its liabilities as they become due. The Company's ability to continue as a going concern is dependent upon its ability to attain profitable operations and generate funds therefrom and to continue to obtain capital financing from investors sufficient to meet current and future obligations.

These financial statements do not reflect the adjustments that would be necessary to the presentation and carrying amounts of the assets and liabilities if the Company were not able to continue operations and these adjustments and reclassifications may be material.

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, C2 Energy Inc. (note 3).

## **Note 2: Significant accounting policies**

These consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. Because a precise determination of many assets and liabilities is dependent upon future events, the preparation of periodic financial statements necessarily involves the use of estimates and approximations. Accordingly, actual results could differ from those estimates. The financial statements have, in management's opinion, been properly prepared using careful judgment within reasonable limits of materiality and within the framework of the significant accounting policies summarized below:

### **a) Principles of consolidation**

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, C2 Energy Inc. and have been prepared by management in accordance with Canadian generally accepted accounting principles. All inter-company balances and transactions have been eliminated on consolidation.

### **b) Cash and cash equivalents**

Cash consists of cash on hand, bank balances, and term deposits of less than 90 days.

### **c) Property and equipment**

#### *i) Capitalized costs*

The Company follows the full cost method of accounting for its petroleum and natural gas operations. Under this method, all costs related to the exploration for and development of petroleum and natural gas reserves are capitalized. Costs include lease acquisition costs, geological and geophysical expenses and costs of drilling both productive and non-productive wells and equipment costs. Proceeds from the sale of properties are applied against capitalized costs and gains or losses are not recognized unless such sale would alter the depletion rate by more than 20%.

#### *ii) Depletion and depreciation*

Depletion and depreciation of undeveloped land, seismic and producing assets, net of estimated salvage or residual value, is provided using the unit-of-production method based upon estimated gross proven petroleum and natural gas reserves as determined by independent engineers. In determining its depletion base, the Company includes the cost of undeveloped land at the rate of 20% per year. For depletion and depreciation purposes, relative volumes of petroleum and natural gas production and reserves are converted at the energy equivalent conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil. Office equipment is depreciated on a declining balance basis over its estimated useful life at rates varying from 20% to 45%.

Office equipment is depreciated on a declining balance basis over its estimated useful life at rates varying from 20% to 45%.

*iii) Impairment test*

In applying the full cost method, the Company calculates a ceiling test whereby the carrying value of property and equipment is compared to the sum of the undiscounted cash flows expected to result from the future production of proven reserves and the cost, less any impairment of unproved properties. Cash flows are based on third party quoted forward prices, adjusted for transportation and quality differentials. Should the ceiling test result in an excess of carrying value, the Company would then measure the amount of impairment by comparing the carrying amounts of property and equipment to an amount equal to the estimated net present value of future cash flows from proven plus probable reserves and the cost of unproved properties. A risk-free interest rate is used to arrive at the net present value of the future cash flows. Any excess carrying would be recorded as a permanent impairment.

Undeveloped land is excluded from the ceiling test and a separate impairment test is performed.

**d) Goodwill**

Goodwill represents the excess of the cost of an acquisition over the net of the amounts assigned to assets acquired and liabilities assumed. Goodwill is not amortized but is tested for impairment at least annually. The Company monitors its goodwill balance to determine whether any impairment has occurred. In order to make that determination, the Company considers the recoverability using the current and estimated cash flows of the underlying business on an undiscounted basis. If this review indicates that goodwill will not be recovered, the Company recognizes a write-down of the unamortized portion of goodwill in excess of its recoverable amount.

**e) Asset retirement obligations**

The Company recognizes the fair value of a liability for an asset retirement obligation in the period in which it is incurred and records a corresponding increase in the carrying value of the related long-lived asset. The fair value is determined through a review of engineering studies, industry guidelines, and management's estimate on a site by site basis. The liability is subsequently adjusted for the passage of time, and is recognized as an accretion expense in the statement of operations. The liability is also adjusted due to revisions in either the timing or the amount of the original estimated cash flows associated with the liability. The increase in the carrying value of the asset is amortized using the unit of production method based on estimated gross proven reserves as determined by independent engineers. Actual costs incurred upon settlement of the asset retirement obligations are charged against the asset retirement obligation to the extent of the liability recorded. Any difference between the actual costs incurred upon settlement of the asset retirement obligations and the recorded liability is recognized as a gain or loss in the Company's statement of operations in the period in which the settlement occurs.

**f) Future income taxes**

The Company follows the liability method of accounting for income taxes. Under this method future tax assets and liabilities are determined based on differences between financial reporting and income tax bases of assets and liabilities, and are measured using substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. The effect on future tax assets and liabilities of a change in tax rates is recognized in net income in the period in which the change is substantively enacted. A valuation allowance is recorded against a future income tax asset if it is more likely than not that the asset will not be realized.

**g) Per share amounts**

The Company utilizes the treasury stock method in the determination of diluted per share amounts. Under this method, the diluted weighted average number of shares is calculated assuming that proceeds arising from the exercise of in-the-money options and other dilutive instruments are used to purchase, for cancellation, common shares of the Company at their average market price for the period.

**h) Stock options**

Under the Company's stock option plan, options to purchase common shares are granted to directors, officers, employees and consultants at current market prices. Stock-based compensation expense is recorded in the statement of operations for all options granted with a corresponding increase recorded as contributed surplus. Compensation expense is based on the estimated fair values on the options at the time of the grant as determined using a Black-Scholes option pricing model. The expense is recognized on a straight-line basis over the vesting period of the option. Upon the exercise of the stock options, the consideration paid together with the amount previously recognized in contributed surplus is recorded as an increase in share capital. In the event that vested options expire, previously recognized compensation expense associated with such stock options is not reversed.

**i) Flow through shares**

Expenditure deductions for income tax purposes related to exploratory activities funded by flow through equity instruments are renounced to investors in accordance with income tax legislation. The Company provides for the future effect on income taxes related to flow through equity instruments as a reduction of share capital and an increase in future income tax liabilities when the renouncement documents are filed with taxation authorities.

**j) Joint operations**

Substantially all of the exploration and production activities of the Company are conducted jointly with others. These financial statements reflect only the Company's proportionate interest in such activities.

**k) Revenue recognition**

Revenue from the sale of petroleum and natural gas production is recognized when title passes to an external party.

**l) Measurement uncertainty**

The amounts recorded for depletion and depreciation of property and equipment and the ceiling test are based on estimates of gross proven reserves, production rates, oil and gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the impact on the consolidated financial statements of changes in such estimates in future periods could be material. Inherent in the fair value calculation of asset retirement obligations, are numerous assumptions and judgments including the ultimate settlement amounts, inflation factors, credit adjusted discount rates, timing of settlement, and changes in the legal and regulatory environments. To the extent future revisions to these assumptions impact the fair value of the existing asset retirement obligation liability, a corresponding adjustment is made to the property and equipment balance.

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option pricing models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee's stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options. By their nature, these estimates are subject to measurement uncertainty and the effect on the consolidated financial statements of changes of estimates in future periods could be significant.

**Note 3: Acquisition of C2 Energy Inc.**

Effective May 20, 2005, the Company purchased all of the issued and outstanding shares of C2 Energy Inc. ("C2"), an oil and gas company for total consideration of \$13,267,600 consisting of \$11,728,219 cash, 3,587,316 warrants of the Company and \$212,346 of transaction costs. Each warrant entitles the holder to purchase one common share of the Company at an exercise price of \$0.60 per share on or before November 20, 2006. The fair value of the warrants has been estimated at \$1,327,035 using the Black-Scholes pricing model assuming a risk-free interest rate of 2.84%; weighted average life of 1.5 years; dividend yield of nil; and expected volatility of 108%.

The acquisition of C2 is an arms-length acquisition accounted for by the purchase method with the Company deemed the acquirer and measured at the exchange amount based on the cash consideration and the estimated fair value of the warrants granted.

The allocation of the purchase price based on the fair values of the assets and liabilities of C2 is as follows:

Cash	\$	23,457
Other current assets		1,113,156
Property and equipment		17,466,161
Goodwill		797,900
Current liabilities		(2,034,388)
Asset retirement obligation		(147,485)
Future income tax liability		(3,951,201)
Net assets acquired	\$	13,267,600
Purchase price		
Cash	\$	11,728,219
3,587,316 warrants		1,327,035
		13,055,254
Transaction costs		212,346
	\$	13,267,600

The consolidated statements of operations and deficit and cash flows include the results of C2 from the date of acquisition.

**Note 4: Property and equipment**

December 31, 2005			
	Cost	Accumulated depletion and depreciation	Net
Petroleum and natural gas properties	\$ 22,296,615	\$ 3,346,073	\$ 18,950,542
Office equipment	47,635	18,027	29,608
	<b>\$ 22,344,250</b>	<b>\$ 3,364,100</b>	<b>\$ 18,980,150</b>

  

December 31, 2004			
	Cost	Accumulated depletion and depreciation	Net
Petroleum and natural gas properties	\$ 3,240,226	\$ 1,181,340	\$ 2,058,886
Office equipment	19,970	11,684	8,286
	<b>\$ 3,260,196</b>	<b>\$ 1,193,024</b>	<b>\$ 2,067,172</b>

The Company did not capitalize any general and administrative costs during 2005 and 2004. As at December 31, 2005, undeveloped land costs of \$3,558,600 (2004 - \$nil) were excluded from the depletion calculation.

The Company applied the ceiling test to its capitalized assets at December 31, 2005 and determined that there was no impairment of costs requiring a write-down. For the purposes of the December 31, 2005 impairment test of property and equipment, the following benchmark prices were used:

	Oil Reference Price (\$/bbl)	Gas Reference Price (\$/mcf)
2006	60.76	10.90
2007	58.45	9.76
2008	54.97	8.70
2009	51.28	7.90
2010	47.62	7.37
2011	48.41	7.50

Thereafter inflation does not exceed 2% per year

**Note 5: Operating loan**

The Company has a revolving operating loan available to a maximum of \$3.0 million at an interest rate of prime plus 1.5%. The effective interest rate on this loan was 6.25% at December 31, 2005 (2004 - 5.75%). A total of \$2,175,000 had been drawn on this facility as at December 31, 2005. The operating loan is secured by a general security agreement over all present and after acquired property and a floating charge on all lands. During 2005, interest in the amount of \$64,346 (2004 - \$67,349) was paid on the loan.

**Note 6: Credit facilities**

- a) In May 2005, the Company obtained a \$4.5 million subordinated bridge facility to assist in the acquisition of C2. The facility had an interest rate of 12% per annum with a \$1.5 million principal repayment required and paid on August 31, 2005 and the balance plus interest due on November 15, 2005. The facility was extended and paid in full in December 2005. A total of \$240,778 of interest and \$90,000 of fees were paid on this facility.
- b) On December 22, 2005, the Company obtained a \$1.8 million subordinated term credit facility with K2 Principal Fund L.P. ("K2"). The facility bears interest at 12% per annum and matures on June 22, 2006. Security on the facility consists of a general security agreement on all of the Company's present and after acquired personal property subordinated to the operating loan (note 5). As part of the facility, K2 was issued 400,000 common shares and granted 1,080,000 stock options. The options are exercisable at \$0.50 per share if the loan is repaid prior to March 31, 2006. If the loan is repaid after March 31, 2006, the options are exercisable at the 10-day volume weighted average trading price, not to be less than \$0.35 per share. The term of the options is three years from the grant date, provided the 10-day volume weighted average trading price does not exceed \$0.75 per share. If the 10-day volume weighted average trading price is greater than \$0.75 per share, the term to expiry is reduced to 90 days.

The \$1.8 million of facility proceeds has been allocated between debt and equity components with \$112,000 as the value of the 400,000 common shares, \$190,828 as the value of the options and the residual amount of \$1,497,172 as debt. The value of the common shares is based on the trading price of the Company's shares on the issue date. The value of the options was estimated using the Black-Scholes option pricing model assuming a risk-free interest rate of 3.5%; weighted average life of 3 years; dividend yield of nil; and expected volatility of 121%.

The debt component will be accreted over the term of the facility by a charge to financing fees on the consolidated statement of operations and deficit and at maturity will be equal to \$1.8 million. At December 31, 2005, accretion of \$14,975 had been recorded to financing fees and added to the debt component, resulting in the \$1,512,147 reported carrying value of the credit facility.

In conjunction with the facility, the Company paid fees of \$120,461, of which \$20,266 has been recorded to share issue costs and \$100,195 to deferred financing fees based on the weighted average debt and equity values of the facility components. Deferred financing fees will be amortized over the term of the facility to financing fees on the consolidated statement of operations and deficit. At December 31, 2005, amortization of \$4,955 had been recorded to financing fees, resulting in the \$95,240 reported carrying value of deferred financing fees.

#### Note 7: Shareholder loans

Two directors of the Company advanced funds to the Company in the amount of \$100,000 and \$200,000, respectively, in exchange for promissory notes. The promissory notes bear interest at 12% per annum, are due on June 22, 2006 and are subordinated to the K2 credit facility (note 6(b)). During 2005, \$2,085 of interest and \$29,000 of fees were paid on these notes.

#### Note 8: Asset retirement obligations

The following table presents the reconciliation of the carrying amount of the obligations associated with the retirement of the Company's property and equipment:

	2005	2004
Asset retirement obligations, beginning of year	\$ 277,340	\$ 297,622
Assumed on acquisition (note 3)	147,485	—
Liabilities incurred	59,445	—
Disposition of property and equipment	(5,308)	(16,353)
Accretion	26,503	22,264
Liabilities settled	—	(803)
Adjustment for change in reserve life, and inflation and discount rates	(38,195)	(25,390)
Asset retirement obligations, end of year	\$ 467,270	\$ 277,340

The following significant assumptions were used to estimate the asset retirement obligations:

	2005	2004
Undiscounted abandonment costs	\$ 1,199,000	\$ 700,000
Credit adjusted risk-free discount rate	8%	8%
Inflation rate	2%	2%
Weighted average expected timing of cash flows	11.6 years	12.7 years

#### Note 9: Share capital

##### a) Authorized

- Unlimited number of Class A voting common shares
- Unlimited number of Class B non-voting common shares

##### b) Issued

Class A common shares	Number of Shares	
Balance – December 31, 2002 and 2003	7,849,780	\$ 810,364
Private placement (i)	400,000	50,617
Exercise of options	284,158	28,416
Share issue costs (net of tax of \$290)	—	(457)
Balance – December 31, 2004	8,533,938	\$ 888,940
flow through share private placement (ii)	6,406,953	3,523,824
Unit private placement (iii)	13,268,000	5,022,367
flow through share private placement (iii)	1,800,000	477,919
Exercise of options (iv)	260,506	38,717
Shares issued to K2 (note 6(b))	400,000	112,000
Share issue costs (net of tax of \$320,373)	—	(1,142,513)
Balance – December 31, 2005	30,669,397	\$ 8,921,254

- (i) Pursuant to a private placement in June 2004, 400,000 units were issued at \$0.15 per unit for gross proceeds of \$60,000. Each unit consisted of one common share plus one-half of one warrant. Each whole warrant entitles the holder to purchase one common share at \$0.40 per share, expiring on May 31, 2006 for which the fair value has been estimated at \$9,383 using the Black-Scholes option pricing model assuming a risk-free interest rate of 4.5%, zero dividend yield, expected life of two years and an expected volatility rate of 112%.

- ii) On May 18 and June 2, 2005 the Company completed a brokered private placement of 6,406,953 common shares on a flow through basis at \$0.55 per share and 13,268,000 units at \$0.50 per unit for total gross proceeds of \$10,157,824. Each unit consists of one common share and one-half of one warrant. Each whole warrant entitles the holder to purchase one common share of the Company at an exercise price of \$0.60 per share on or before November 18, 2006 and December 2, 2006. Directors of the Company purchased 890,000 units and 206,364 flow through shares. The warrants have been ascribed a fair value of \$1,611,633 using the Black-Scholes option pricing model assuming a risk-free interest rate of 2.84%; weighted average life of 1.5 years; dividend yield of nil; and expected volatility rate of 121%.

In addition to a cash commission of \$734,342, the agent received options to purchase 1,326,800 units, as described above, at \$0.50 per unit and options to purchase 640,695 common shares at \$0.55 per share on or before November 18, 2006. The fair value of the share and unit options has been recorded as share issue costs estimated at \$509,959 using the Black-Scholes pricing model assuming a risk-free interest rate of 2.84%; weighted average life of 1.5 years; dividend yield of nil; and expected volatility rate of 121%.

- iii) On July 18, 2005 the Company completed a private placement of 1,800,000 flow through shares at a price of \$0.55 per share for gross proceeds of \$990,000. Attached to each flow through share is a warrant entitling the holder to purchase one additional share, on a flow through basis at a price of \$0.75 per share on or before January 18, 2007. The warrants have been ascribed a fair value of \$512,081 using the Black-Scholes pricing model assuming a risk-free interest rate of 3.05%; weighted average life of 1.5 years; dividend yield of nil; and expected volatility rate of 121%.

- iv) A total of 260,506 options were exercised for cash proceeds of \$26,426. In addition to the cash proceeds the pro-rata allocation of the stock option's fair value in the amount of \$12,291 has been reclassified to the amount for share capital.

#### c) Flow through shares

During 2005, the Company issued a total of 8,206,953 flow through common shares for gross proceeds of \$4,513,824 for which the Company has until December 31, 2006 to incur the related qualifying expenditures. The tax benefits of the flow through proceeds were renounced to investors and filed with taxation authorities in February 2006 with an effective date of December 31, 2005. As at December 31, 2005, approximately \$ 1,177,000 of qualifying expenditures had been incurred and the balance of approximately \$3,336,800 must be incurred by December 31, 2006.

#### d) Options

The Company has a stock option plan, administered by the Board of Directors, in which up to 10% of the issued and outstanding common shares are reserved for issuance at current market prices. Under the plan, the options vest immediately and expire five years from date of grant.

The following is a continuity of stock options outstanding for which shares have been reserved:

	Year ended December 31, 2005		Year ended December 31, 2004	
	Number of options	Weighted Average Exercise Price	Number of options	Weighted Average Exercise Price
Opening	1,285,798	\$ 0.10	1,310,121	\$ 0.10
Granted	3,047,495	0.51	259,835	0.11
Exercised	(260,506)	0.10	(284,158)	0.10
Closing	4,072,787	\$ 0.41	1,285,798	\$ 0.10

The following summarizes information about stock options outstanding at December 31, 2005:

Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life (years)	Number Exercisable	Weighted Average Exercise Price
\$ 0.10	802,958	0.3	802,958	\$ 0.10
\$ 0.11	222,334	3.2	222,334	0.11
\$ 0.50	2,406,800	1.8	2,406,800	0.50
\$ 0.55	640,695	0.9	640,695	0.55
	4,072,787	1.5	4,072,787	\$ 0.41

e) Per share amounts

Per share calculations are based on the weighted average number of common shares outstanding during the year of 21,631,797 (2004 – 8,105,089). In computing diluted per share amounts, all of the Company's outstanding options and warrants have been excluded as they are anti-dilutive.

**Note 10: Warrants**

	Weighted average exercise price	Number	Ascribed value
Balance – December 31, 2004	\$ 0.40	200,000	\$ 9,383
Unit private placement (note 9(b)(iii))	0.60	6,634,000	1,611,633
Acquisition of C2 (note 3)	0.60	3,587,316	1,327,035
flow through unit private placement (note 9(b)(iii))	0.75	1,800,000	512,081
Balance – December 31, 2005	\$ 0.62	12,221,316	\$ 3,460,132

The following table summarizes information about warrants outstanding at December 31, 2005:

Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life (years)	Number Exercisable	Weighted Average Exercise Price
\$ 0.40	200,000	0.4	200,000	\$ 0.40
\$ 0.60	10,221,316	0.9	10,221,316	0.60
\$ 0.75	1,800,000	0.9	1,800,000	0.75
	12,221,316	0.9	12,221,316	\$ 0.62

**Note 11: Contributed Surplus**

Balance – December 31, 2003	\$ –
Stock-based compensation expense	85,164
Balance – December 31, 2004	\$ 85,164
Private placement agent options (note 9(b)(iii))	509,959
Exercise of options (note 9(b)(iv))	(12,291)
Credit facility options (note 6(b))	190,828
Balance – December 31, 2005	\$ 773,660

**Note 12: Income taxes**

The Company's computation of future tax (recovery) provision is as follows:

	2005	2004
Expected income tax recovery at 37.62% (2004 – 38.87%)	\$ (471,640)	\$ (13,893)
Non-deductible Crown charges	127,444	49,202
Alberta Royalty Tax Credit	(39,344)	(7,393)
Resource allowance	(86,804)	(38,450)
Benefit of provincial tax deduction	(21,362)	7,182
Stock based compensation	–	33,103
Rate adjustments and other	37,520	8,974
	\$ (454,186)	\$ 38,725

The components of the net future income tax liability are as follows:

	2005	2004
Future income tax liabilities		
Carrying amount of property and equipment in excess of tax basis	\$ (4,326,714)	\$ (299,515)
Future income tax assets		
Asset retirement obligations	157,096	107,802
Effect of provincial tax deduction	177,962	33,989
Non-capital losses	10,113	6,273
flow through expenditures	395,975	
Share issue costs and financing fees	257,949	474
	\$ (3,327,619)	\$ (150,977)

As at December 31, 2005, the Company has approximately \$6.1 million of tax pools and \$31,000 of non-capital losses available for deduction against future taxable income. Non-capital losses expire between 2010 and 2014.

**Note 13: Commitment**

The Company has the following annual rental commitments on office premises pursuant to a lease, which expires on December 31, 2008:

2006	\$ 36,540
2007	38,367
2008	40,194
	<u>\$ 115,101</u>

The Company indemnifies its directors and officers against any and all claims or losses reasonably incurred in the performance of their service to the Company to the extent permitted by law.

**Note 14: Financial instruments****a) Fair values of financial assets and liabilities**

Financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, operating loan, credit facility and shareholders' loans. At December 31, 2005 and 2004 there are no significant differences between the carrying amounts reported on the balance sheet and their estimated fair values. The Company has not entered into any hedging contracts.

**b) Interest rate risk**

The Company is exposed to a floating rate of interest on its bank borrowings.

**c) Credit risk**

The majority of the accounts receivable are in respect of oil and natural gas operations. The Company generally extends unsecured credit to these customers, and therefore, the collection of accounts receivables may be affected by changes in economic or other conditions and may accordingly impact the Company's overall credit risk. Of the Company's significant individual accounts receivable as at December 31, 2005, approximately 37% (2004 – 40%) was due from one corporation. The Company has not experienced any material credit loss in the collection of receivables in the past. All of the Company's cash is held at one institution and as a result of this and the nature of its operations, the Company has concentration of credit risk.

**Note 15: Changes in non-cash working capital**

	2005	2004
Accounts receivable	\$ 400,692	\$ (58,693)
Prepaid expenses and deposits	6,677	(23,581)
Accounts payable and accrued liabilities	(130,451)	53,174
	<u>\$ 276,918</u>	<u>\$ (29,100)</u>

The change in non-cash working capital has been allocated to the following activities:

	2005	2004
Operating	\$ 1,395,859	\$ (45,350)
Investing	(1,118,941)	16,250
	<u>\$ 276,918</u>	<u>\$ (29,100)</u>

**Note 16: Related party transactions**

Except as disclosed elsewhere in these consolidated financial statements, the Company had the following related party transactions:

- During the year ended December 31, 2005, the Company was charged \$37,500 (2004 – \$90,000) by an officer and director for administrative, geological and consulting services. The director, pursuant to an agreement signed by the Company in January 2001, was also paid an overriding royalty on certain wells in the amount of \$12,518 (2004 – \$11,821). The director lent funds to the Company in 2005 and collected \$19,333 in fees and \$1,723 in interest (*note 7*).
- A director lent funds to the Company in 2005 and collected \$9,667 in fees and \$362 in interest during 2005 (*note 7*).

These amounts are recorded at the exchange amounts agreed to by the related parties and are on the same terms and conditions as those negotiated with third parties.

**Note 17: Subsequent event**

In January 2006, the Company granted 985,000 stock options exercisable at \$0.50 per share and 1,015,000 stock options exercisable at \$0.44 per share to employees, directors and consultants. In March 2006, an additional 300,000 stock options exercisable at \$0.36 per share were granted to an employee. The options vest immediately and expire five years from date of grant.



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